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TAGS: ECON EFIN ETRD CE ECONOMICS
SUBJECT: NEW TAX SQUEEZE PRIOR TO UNVEILING SRI LANKAN BUDGET

¶1. (SBU) Summary: The Government of Sri Lanka has introduced a series of politically motivated taxes just prior to its presentation of the 2005 budget. Most of the taxes attempt to satisfy the Marxist elements in the current government, who want to be seen as protectors of the national heritage, rural farmers and local businessmen. The Finance Ministry says the measures are needed to protect the fast-depleting foreign reserves and protect industries from dumping. Some of the taxes have come into effect with retroactive charges to 2002. These taxes are indicative of the cash flow problem faced by the GSL. The timing of the tax announcement, just prior to the new budget, may be an attempt to make the new budget appear less of a burden and more generous. End Summary.

¶2. (U) Below is a list of recent tax measures followed by detailed information on each tax:

-- 100% tax on sale of land and property to foreign nationals (including companies with over 25 percent foreign equity)
-- Repeal of 2002-tax amnesty
-- Hike in duty on motor vehicle imports
-- New duty on non-essential imports
-- A tax on Government securities transaction with retroactive effect to 2002
-- Economic Service Charge on turnover of companies

Tax on property

¶3. (SBU) The first tax to be introduced by this Government was a 100 percent transfer tax on property sales to foreign nationals and companies. This tax was mooted by the Janatha Vimukthi Peramuna (JVP), a key element of the current ruling coalition, following extensive press coverage of property purchases by foreigners, after the abolition of a 100 percent transfer tax in 2002.

¶4. (U) In particular, significant negative publicity was focused on real estate purchases inside the historic Dutch fort in Galle, and along the southern coastal belt, both JVP strongholds. Foreign land ownership was a hot issue in the April 2004 election campaign, with the UPFA promising to stop foreign land purchases if elected. The new law, however, goes beyond the previous property tax as it also covers local companies with more than 25 percent foreign equity. It also requires a government assessment of land value for land sold to foreigners. For these reasons it has been heavily criticized by the business community.

¶5. (SBU) According to a partner at a leading law firm, his firm is recommending against land purchases by foreign clients as a result of the tax and uncertainties surrounding implementation of the value assessment requirement. A Finance Ministry official told EconFSN that the Ministry is seeking to amend that requirement and also to give power to the Finance Minister to exempt companies from the tax on a case-by-case basis. Contacts at the Colombo Stock Exchange indicate they have not heard many complaints from listed companies with over 25% foreign holding, but that most firms could circumvent the tax by creating a new, wholly-Sri Lankan-owned corporation for property holdings.

Repeal of Tax Amnesty

¶6. (U) The Government has also moved to repeal (parts of) a controversial tax amnesty granted by the previous government. The amnesty was declared in 2003, allowing people to declare undisclosed assets and income, and also obtain waivers from a range of unpaid taxes. The purpose of the amnesty, according to the previous Finance Minister, was to

widen the tax net. The amnesty attracted 58,000 applications, all of which would be added to the tax rolls.

¶7. (SBU) The President and the new government criticized the amnesty, saying that it paved the way for corrupt supporters of the previous Government and tax dodgers to escape from their tax liabilities. In addition, the Government has said that tax collections have decreased due to the amnesty. The main criticism has been the coverage of indirect taxes (Goods and Services Tax (GST - a precursor to the Value Added Tax implemented in 2002), excise tax, import and export duties) enabling large-scale tax evasion.

¶8. (U) According to the new legislation, taxpayers will still be able to qualify for amnesty on income tax, but not on other indirect taxes. Finance Ministry officials argue that these indirect taxes have already been recovered by businesses from consumers (such as GST on consumer products) and should be rightly paid back to the Government. The business community, especially the powerful Ceylon Chamber of Commerce, has expressed reservations on the repeal of the tax amnesty, saying it has compromised the credibility of the government in the investor community.

Duty on motor vehicle imports

¶9. (U) The government has also begun to increase taxes on imported items. The first in line were motor vehicles. The excise duty on gasoline-powered cars was increased from 25 percent to 30-60 percent, based on engine capacity. Smaller vehicles will be assessed a lower duty and bigger vehicles at a higher duty (at the lower duty range -- cars under 1000 cc -- the market consists mostly of the Indian made "Maruti" and the locally produced "Micron").

¶10. (U) Excise duty on diesel cars have been increased from 60 percent to 115 percent. The excise duty on gasoline powered vans has been increased from about 15 percent to 30% and diesel powered from about 48 percent to 84 percent.

¶11. (U) In addition to increased duty, importers of motor vehicles are now required to pay up front when opening letters of credit. The Central Bank said these steps should help to reduce vehicle imports, curb high credit growth to the private sector, reduce the burden on the fuel bill and reduce road congestion. The increased duty on motor vehicles has come under sharp criticism by vehicle importers, who say they are unable to pay higher prices for imports already made. At least one importer has obtained an order restraining the government from implementing the new tax.

Import duty on non-essentials

¶12. (U) The Government has also introduced a tariff on a range of "non-essential" imports including fruits, vegetables, processed and unprocessed food, shoes, bags, rubber and plastic products, textile products (other than fabric), consumer items such as toiletries and perfumes, ceramic ware, glass ware, pens and electrical goods. The tax is three tiered: 10, 15 and 20 percent, with most of the items also carrying a specific (piece rate) duty. The higher of the two rates will be charged. Some of the specific duties would amount to a 100 percent tax as in the case of ballpoint pens, which are charged a duty of 10 rupees (about 9 US cents) per item. The tariff, ostensibly imposed for Sri Lanka's Export Development Board, will be in addition to normal import duty and the 10 percent duty surcharge currently in effect. The tax will send Sri Lanka's import duty structure sharply upwards.

¶13. (SBU) The Finance Ministry in a press release said that this measure intends to "discourage the importation of nonessentials in view of the foreign exchange crises faced by the government due to the escalation of world oil prices". However, the real reason appears to be a politically motivated move to protect the local industry as indicated previously in the July 2004 Economic Policy Framework (EPF), which declared that SME's must be offered protection from being displaced by unfair import competition. The Finance Ministry Statement also said that the government has been informed of severe competition faced by the farmers and local industries due to

dumping. Further, the statement indicated that the Customs Department finds it difficult to ascertain the true value of imports. Although the release said the income would be used for export development, it is most likely that proceeds will go to the treasury.

¶14. (SBU) The Department of Commerce has not yet carried out a study of the impact of these measures on Sri Lanka's WTO obligations. Since Sri Lanka's bound duty on agriculture is around 50 percent (for import tariff) and 10 percent (for other charges), and most non-agricultural products (except for textiles) are not bound, they hope these measures will not cause serious problems for Sri Lanka at the WTO.

Taxes with retroactive effect

¶15. (U) Two other taxes have been introduced with retroactive effect. They include taxation of trading profits and interest income of secondary market transaction of securities, treasury bills and other government bonds with retroactive effect, from April 2002. Financial institutions have complained about this move, especially as profits attributable to the past years have been already paid to shareholders.

Economic Service Charge (ESC)

¶16. (U) The Government has also taken steps to implement a 1 percent ESC proposed by the last government. ESC can be set off against income tax payable during the year. While the ESC was proposed on either a turnover or asset basis, the current government has implemented the tax on the basis of turnover.

Comment

¶17. (SBU) The current state of the GSL's fiscal situation is troubled. Retroactive taxes appear indicative of how low cash reserves have fallen. Oil prices, a general lack of business confidence and a surge in intermediate goods imports have put pressure on the rupee, and the Central Bank has intervened heavily to smooth its depreciation (approximately 7 percent since January 1). While few expect these taxes to be major revenue earners, the Government hopes that they will help slow the outflow of foreign reserves.

¶18. (SBU) By imposing these measures through gazette notification, rather than the budget process, however, some believe the GSL is setting itself up to unveil a budget that is filled with benefits (higher public sector salaries, possibly increased agricultural subsidies), but that does not impose serious revenue or belt-tightening initiatives. These taxes are also indicative, though, of the current GSL's general leanings toward import-substitution and protectionist policies, as promised in its Economic Policy Framework. End comment.